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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
P. O. Box 15196
San Diego 15, California

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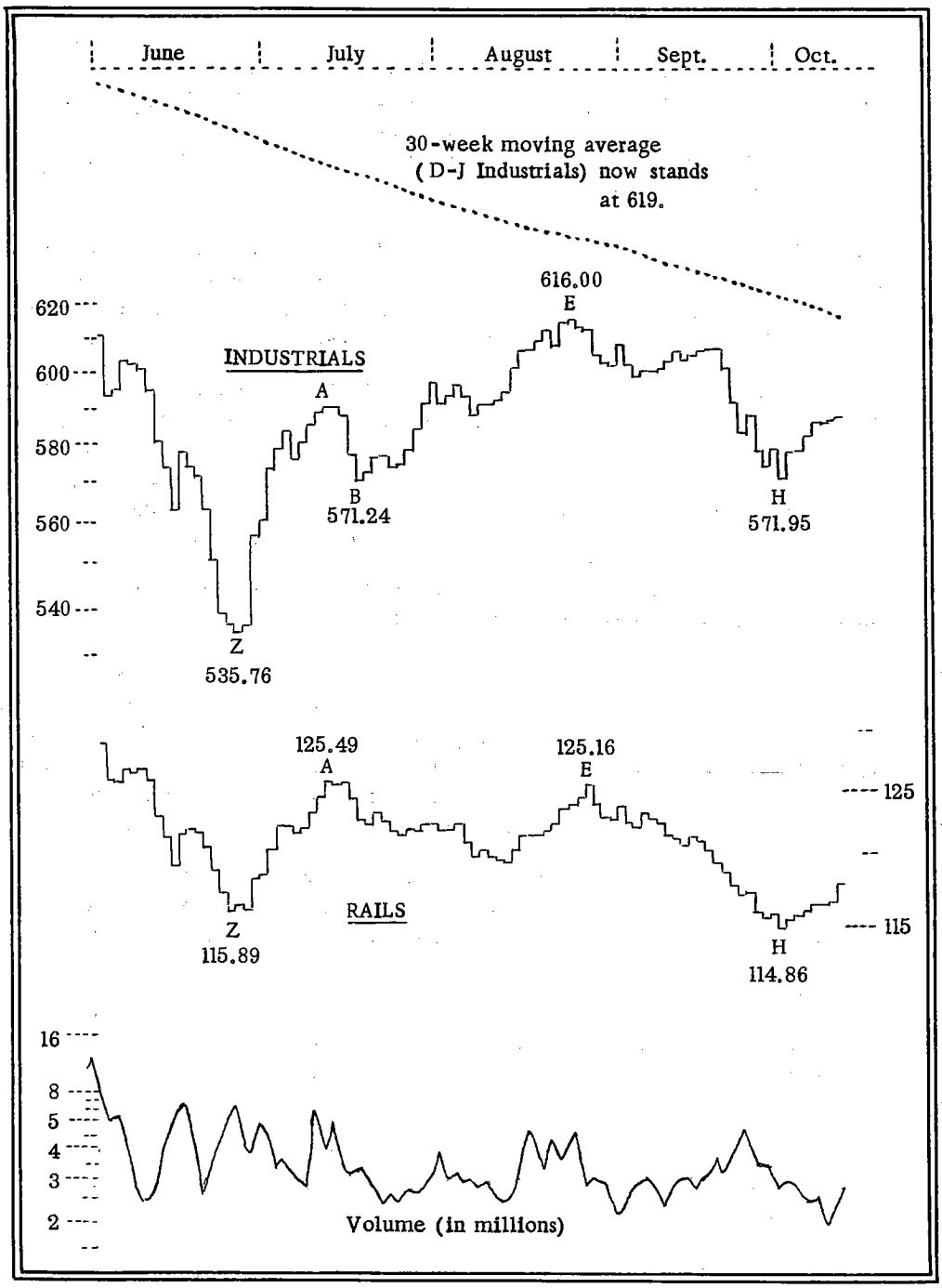
THE MARKET On the first leg of the recovery which started on June 27, volume expanded noticeably and on July 10 and July 12 (both rally days) we saw volume of 7 and 5 million shares respectively (at point A on the chart). On the second leg of the recovery (the leg which took Industrials to a peak of 616.00 at E) volume receded from earlier levels but held around the 4-5 million share mark.

Following the unconfirmed Industrial peak at 616.00, the Averages turned down. On the decline Rails broke to a new bear market low of 114.86. Industrials recorded a low of 571.95 (H) on October 1, but this point was 71¢ above the July 18 low of 571.24 (B) and 36 points above the Industrial bear market low of 535.76 (Z). The refusal by Industrials to penetrate their 571.24 (B) low led to the most recent rally.



The rally from H has been characterized by a sharp contraction in volume. The first day of the rally (October 2) produced volume of 3 million shares. But volume has contracted since October 2, and on the five trading days between Oct. 4 and Oct. 9 volume averaged 2.3 million shares.

Thus we have the spectacle of diminishing trading activity on three upward thrusts from the June lows. Diminishing volume on successive rallies cannot be considered definitely bearish. However, it must be taken as negative action. If the next decline is accompanied by expanding trading activity, and if on the next decline, Industrials break below 571.24 (B) the picture will appear extremely bearish. In the meantime, as long as Industrials hold above 571.24 (regardless of volume) there remains the possibility that the 44 point drop from E to H will be subject to further retracement and correction.

THE PRIMARY TREND During a bear market the better part of

our energy should be directed toward one question -- Is the primary downward force continuing? Or put another way -- Are there any indications that the bear market liquidation is drawing to a close?

Over the past year I have applied (and will continue to apply) a variety of methods and gauges in a constant attempt to check and re-check the direction of the all-important primary trend. These studies include (1) the pattern of the Averages, (2) volume, (3) phases of bull and bear markets, (4) advance-decline ratio, (5) new highs and lows, (6) values and average yields, (7) market psychology (i.e., short interest, odd-lots, contrary opinion, general investor psychology), (8) relationship of D-J Industrials to their own 30-week moving average, (9) the 50% Principle, (10) relationship of 346 representative stocks to their 30-week moving averages, (11) patterns of "key" individual stocks such as IBM and American Telephone, (12) general discussions of characteristics of bull markets, bear markets, and most important at present -- bear market bottoms.

This concept of the primary trend is the most basic, the most theoretical, and the most difficult of all to get over to the average investor. The primary trend may be likened (and Hamilton did just this) to the tide of the ocean. When the primary trend is down, the direction of everything -- stock prices, the economy, wholesale and commodity prices -- will move inexorably down. There will be pauses, there will be rallies, but as long as it's a bear market no amount of talk, manipulation or governmental intervention will stop the downward course of stocks and the economy. A bear market will continue in force until the worst that can be foreseen is fully discounted in the price structure.

This concept is the basic platform upon which Dow's Theory stands. Yet the very theoretical nature of this "unseen, all-powerful force theory" is repugnant to most investors. People demand "tangible" explanations; they want to know why -- why can some "mysterious force" exert downward pressure on the economy. The Average investor can easily comprehend direct cause and effect -- if unexpected bad news hits a stock, well, then it should go down. But the same person seems emotionally incapable of grasping the tidal principle of Dow's Theory -- and this failing has been responsible for more major mistakes in the market than has any other factor.

INSIDE INFORMATION Last week one of the partners in a New York brokerage firm called. "I've just had lunch with a highly placed officer of a large mutual fund," he said. "I cannot disclose the name of the fund, but I have the highest respect for this man. He told me that their fund has concluded that the 571.24 Industrial level has been 'successfully tested' and that they believe that the lows for 1962 have been seen. I was wondering how this jibes with your opinion."

"The market is a 'lone wolf' business," I answered. "In the final analysis, the decision to buy or sell must (and should) be a personal one. 'Inside information' is always available. Consciously or unconsciously, the man who provides inside information is either expressing his wishes or attempting to mould opinion. The truly successful market practitioner, said Hamilton, is curiously rather inarticulate. As far as your friend is concerned, I happen to be sceptical of his conclusion. Furthermore, I am just as sceptical of the fact that he imparted this information to you. Personally, I would be inclined to treat his opinion as a 'market tip'. As such, forget it, and continue to do your own thinking."

Why should we be sceptical of all "inside information" during the course of a major bull or bear market? Wise words along these lines were written by Richard Schabacker in 1929.

"CHARACTERISTICS OF THE END OF A BEAR MARKET: Now the market 'makes the front page' because of its declines instead of its advances. Now the tips and rumors are all on the unfavorable side. This stock is going to have to cut its dividend or pass it. That stock is still too high and is going to drop another 25 points in the next few weeks. This company is on the verge of receivership and is going bankrupt. Even the Twelfth Village Bank is whispered to be in sore difficulties and likely to go under. The country has suffered a death blow. Prosperity may come back some day, but it will be a long, hard pull, and there is no telling how much further down stocks are going before the turn comes.

"What is the result? Just what the insiders are working for. Public confidence is demoralized. The average investor is tied up with his heavy load of stocks accumulated in those rosy days, now seemingly gone forever. The professional speculator and the wise long-swing investor, all have sold their stocks, though perhaps at huge losses, long ago.

"Now comes the danger for the long-pull investor. Yes, he bought with the idea that nothing could induce him to sell. He was going to hold for long-pull appreciation and pay no attention to intermediate reactions. But now -- why, the country is going to the dogs, the stocks that looked so good a year or two ago now look weak enough for receivership. Selling would mean a tremendous loss, but maybe if he sells now he can recoup some of his losses by buying his stocks back later at still lower prices.

"This is the tragedy of the long-pull investor. It is no exaggeration to say that the greatest amount of public selling is done in such a situation, just when stocks ought to be bought instead of sold. The public usually sells at this seemingly darkest moment, when stocks should be purchased for the long-swing.

"The public generally loses. It loses because it listens to such frothings of gossip, rumors and tips, instead of digging into the actual facts. But from a logical standpoint, how are the professionals, the students, the authorities going to accumulate stock to cover their short commitments made in previous distribution periods, long ago at higher prices? How are they going to

accumulate additional stock for the next bull market, if they cannot discourage the public to sell their basically sound stocks at the bottom of the bear market?"

Schabacker, Dow, Hamilton and Rhea were wise men; moreover, they had the advantage of having lived through many bull and bear markets. The questions I ask myself as I read the above passage are: Have we seen the stage wherein the public has completely lost confidence? Has the public finally thrown in the shares which were purchased over the past four or five years? Is it the general consensus that "the market is heading much lower?" Is the public disinterested in sound stocks which are selling below values? Is the market at the stage where large interests are ready to accumulate great values at bargain prices? In every case I must answer -- I don't think so.

I know few people who have actually sold all their stocks in 1961 and 1962. I know few people who really expect a lower market now. When I do hear bearishness, it comes from people who tell me how bearish everybody else is (implying, of course, that the situation is really bullish).

In the light of the above, I will ask subscribers how they should take bullish statements which come from highly-placed fund officers at this time. It seems to me that such statements should be viewed with the thought that these interests are trying to "make a market." I do not associate bullish statements from insiders with the formation of a major bear market bottom. Schabacker didn't, and I suggest that my subscribers follow his example.

SHORTS I do not believe I have ever heard so much talk about the short interest on the New York Stock Exchange. Most analysts take the current 5-million-plus short position on the New York Stock Exchange to be a positively bullish force on the market. "Every short seller has to buy 'em back", we are told, "and this constitutes a reservoir of potential buy orders." This is all very true -- but no one has specified at what levels the shorts must "buy 'em back."

The critical factor when analyzing the short position is the direction of the primary trend. When the tidal (primary) force of the market is bullish and too many shorts gather, this is an indication that too much bearishness has been generated within a primary bull trend. Often, during a typically short (three weeks to three months) bull market reaction we will see a great expansion in the total short interest. This rising short interest usually occurs at or near the bottom of the reaction -- after the averages have discounted the worst. In the inevitable rise which follows, the shorts are squeezed out as the primary bull trend reasserts itself. I view a large short interest within a bull market as an indication of too much bearishness -- rather than a definite "buying force." When excessive pessimism develops within a bull market, the odds favor the market's already having discounted the worst.

This is not true of a primary bear market; during an extended bear trend the primary force is working for the short seller. It should be remembered that most of today's analysts have been writing since the 1940's or '50's. They have never seen a bear market which has been accompanied by great public (speculative) interest.

The last such bear market was 1929-32. The first short interest figure ever issued by the N. Y. Stock Exchange was that of May 25, 1931. The short interest at that time was 5.5 million shares. In May, 1931, the Industrial Average stood at 130. By December, 1931, the Average was 73. The shorts had made a killing, and by the end of the year 1931 the total short interest had dropped to 2.8 million shares. A rally carried through to March of 1932. The total short interest rose to 3.5 million in January, 1932 and 3.3 million in March at the rally peak. Following this increase in the short interest the Averages went into the worst percentage decline in history (March to July, 1932). Again the shorts were correct.

It seems to me that during a bear market (following a great and active bull market) we can expect to have a continuing large short interest. But this does not necessarily mean that the shorts must lose money. During a bull market nobody asks how all those buyers can be right! Yet during a bear market one constantly hears that "all those shorts must be wrong."

As an example, Korvette's short interest rose from 31 thousand in December, 1961 (price 40) to 116 thousand in April when the stock advanced to an all-time high of 57. KOR then broke with the market, touching a low of 33 in June. The shorts made a killing (many of them on excellent fundamental information, no doubt). KOR then rallied to an August high of 47 and the short position in KOR rose to a new high of 173 thousand shares (this represented about 4% of the outstanding stock!) From the August peak, KOR fell below 30 (last week). As a broker-friend of mine said a few days ago, "I should have been one of those 'crowded' Korvette shorts." All of which suggests that the position of the short seller during an extended bear market is a vastly different thing from the position of the short during a primary bull market.

STOCKS Of 346 representative stocks which are watched with particular care at this office, 26 are now above their long-term or 30-week moving average. This is an increase of 14 since October 2, but 7 less than September 24. The total is still below 10% and therefore unimpressive.

The recovery since the June lows has succeeded in arousing Wall Street's hopes, and this is not abnormal. However, I have attempted to point out that important moves (and certainly primary reversals) take a long time, are accompanied by real accumulation patterns in individual stocks, and generally arrive at a time when the majority is dead bearish. I have called particular attention to individual stock patterns which formed at and around the June lows. In most cases, volume was not correct, the formations were bear market formations (i.e., wedges, fanlines, straight-up moves on diminishing volume) and the upside breakouts did not "carry through."

The recently spectacular Korvette provides a textbook study in itself. KOR dropped from an all-time high of 57 (April, 1962) to a low of 32 3/4 in May. This "crash-action" was followed by a persistent recovery movement.

The June-September rise in KOR can be measured by the lower trendline (marked A) on the chart. Taking the first recovery peak at point 1 as the top of a rising channel, a second (upper) trendline (C) can be drawn parallel to trendline A. As KOR rallied, three things were apparent: (1) the stock was rising out of an extremely short base, (2) the stock was unable (on rallies) to touch the upper limit (trendline C) of the channel, (3) volume was diminishing.

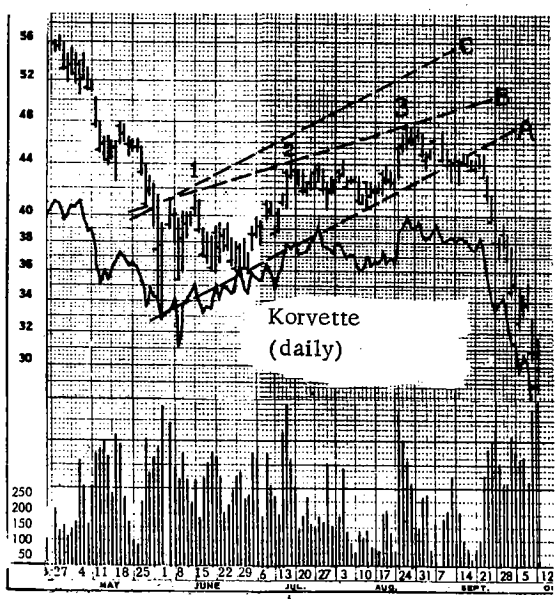
In a true bull move, many stocks tend to rise within definite upward (parallel) channel lines. However, if (as the rise progresses) the stock is unable to meet its upward channel line, it is a sign of weakness. As a rule, when a stock fails on two successive rallies to meet its upper channel line, the odds are favorable for a reversal.

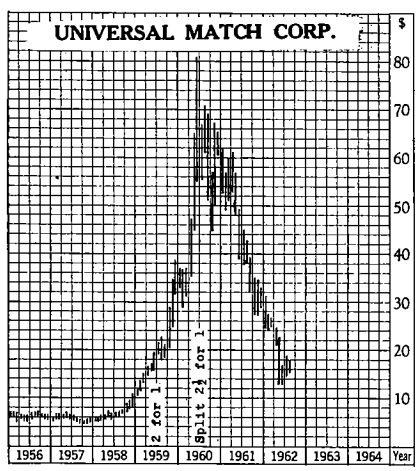
Many readers will immediately recognize such action as the rational for the rising wedge (see Letter 192), and it is apparent that trendlines A and B traced a rising wedge in KOR. This pattern suggested a rally in which buying power was being exhausted. When KOR broke below A, the stock dropped sharply to new lows. The wedge had told a story of a technical rally which had "run out of steam."

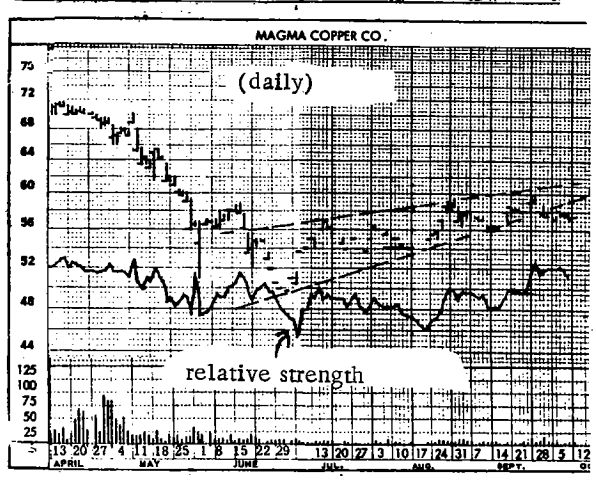
Magma Copper currently is in a large rising wedge. The upside action (within the wedge) is so thin that the stock has filled the wedge with a series of gaps. Note the almost total disappearance of volume on the rise. Over the last week Magma has drifted through the lower wedge trendline. The stock should now move lower, but trading has been so sparse that shorts will almost certainly have to be put out in odd-lots. Any downside volume should send Magma sharply lower.

LATE MARKET NOTES (Written Thursday, October 11, noon N.Y. time): Yesterday's action provided hints of a turn to the downside. Industrials rallied over 4 points in the morning, but this writer was interested to note that three prime leaders, GM, AT & T and IBM were down all day. Selling pressure appeared in the afternoon, and by the close Industrials had whittled their lead to 96¢. Eight of the ten of the day's most active issues were down, and total volume rose to above 3 million shares for the first time since October 2. This morning (Thursday) the market turned dull on the downside with most prices fluctuating rather aimlessly. The ability or inability of Industrials to hold above 571.24 is the key to the near-term trend.

PSYCHOLOGY When Universal Match shot up from 6 to over 80 (1958-60) everybody knew about this "growth company" which had appreciated "over 1000%" in a matter of a few years. Now that the stock is almost back to where it came from, nobody talks about the company which has lost a fabulous 85% of its listed value in less than two years.







Charts of KOR and Magma courtesy of Trader's Research, P.O. Box 2644, St. Louis 16, Mo. Chart of Univ. Match from M.C. Horsey, 37 Wall St., N.Y.C. 5.